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October 1, 2010

The Honorable Jocelyn Boyd
Chief Clerk of the Commission
Public Service Commission of South Carolina
Post Office Drawer 11649
Columbia, South Carolina 29211

Re: Complaint and Petition for Relief of BellSouth Telecommunications, Inc. d/b/a AT&T Southeast d/b/a AT&T South Carolina v. Affordable Phone Services, Inc. d/b/a High Tech Communications, Dialtone & More, Inc., Tennessee Telephone Service, LLC d/b/a Freedom Communications USA, LLC, OneTone Telecom, Inc., dPi Teleconnect, LLC and Image Access, Inc., d/b/a New Phone
Docket No. 2010-14-C, Docket No. 2010-15-C, Docket No. 2010-16-C, Docket No. 2010-17-C, Docket No. 2010-18-C, & Docket No. 2010-19-C

Dear Ms. Boyd:

Enclosed for filing is AT&T South Carolina's Rebuttal Testimony of Dr. William E. Taylor in the above-referenced matters.

By copy of this letter, I am serving all parties of record with a copy of this testimony as indicated on the attached Certificate of Service.

Sincerely,

Patrick Turner

Patrick W. Turner

PWT/nml
Enclosure
cc: All Parties of Record
853193

ON BEHALF OF BELLSOUTH TELECOMMUNICATIONS, INC.

REBUTTAL TESTIMONY OF DR. WILLIAM E. TAYLOR

BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DOCKET NOS. 2010-14-C TO 2010-19-C

OCTOBER 1, 2010

I. INTRODUCTION AND SUMMARY

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND CURRENT POSITION.

A. My name is William E. Taylor. I am a Special Consultant to NERA Economic Consulting, Inc. (NERA), 200 Clarendon Street, Boston, Massachusetts 02116. I filed direct testimony in this proceeding on August 27, 2010, which outlined my qualifications.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been asked to respond to the economic issues raised in the direct testimonies of Dr. Klein and Mr. Gillan filed in this proceeding on August 27, 2010.

Q. WHAT ECONOMIC ISSUES WERE RAISED BY DR. KLEIN AND MR. GILLAN?

A. Both witnesses claim that AT&T should resell all three promotions in question — cashbacks, Line Connection Charge Waivers ("LCCWs") and Word-of-Mouth promotions ("WoM") — and that the full effect of each promotion on the retail price should be applied to the wholesale price.

Q. DO YOU AGREE WITH THESE CONCLUSIONS?

A. No. Under the assumptions in this proceeding,[1] I concluded in my Direct Testimony that the Commission should determine the effects of the cashback and LCCW promotions on the retail price of the telecommunications service and then calculate the wholesale price by applying the avoided-cost discount to the new retail price. For the WoM program, I concluded that those promotions were marketing costs, not effective reductions in the retail price and therefore were not required to be resold. If the Commission were to find otherwise and require that the WoM promotion be resold, my testimony concluded that the wholesale price of the telecommunications service would be unchanged by the promotion.

Q. HOW IS YOUR REBUTTAL TESTIMONY ORGANIZED?

A. Section II of my testimony addresses cashback offerings. In Subsection II.A, I explain that AT&T appropriately treats a $50 cashback offering as a $50 price reduction by providing qualifying resellers a bill credit of $42.50 (which is the

[1] In the July 23, 2010 Stipulations for Consolidated Phase ("Stipulations"), the Parties ask the Commission to assume that AT&T was required to resell the cashback and LCCW promotions and to determine the relevant wholesale price. For the WoM promotion, the Parties ask the Commission to determine if the program is required to be resold and, if so, to determine the appropriate wholesale price for the underlying telecommunications service.

$50 retail value of the cashback, reduced by the Commission-approved 14.8 percent resale discount). In Subsection II.B, I explain that the resellers' contention that AT&T must provide resellers a credit in the full $50 retail amount is contrary to FCC Orders and Rules addressing resale; this Commission's decision establishing the 14.8 percent resale discount rate; the plain language of the parties' interconnection agreements (which were approved by this Commission); and the way the resale discount rate has been applied for more than a decade. In Subsection II.C, I explain that despite Dr. Klein's assertions to the contrary, AT&T's discounted cashback method does not create a price squeeze. In Subsection II.D, I explain why, contrary to Dr. Klein's conclusion, AT&T would not be financially indifferent between selling services at retail and wholesale if it gave resellers a bill credit in the full retail value of the cashback.

Section III applies these principles to promotions that waive a line connection charge for a qualifying retail customer . Specifically, this Section refutes Dr. Klein's blatantly erroneous contention that instead of waiving the wholesale charge for a reseller whose customer qualifies (which AT&T does), AT&T must actually *pay* the reseller to connect one of its customers who qualifies for the promotion.

Section IV shows that WoM promotions are not price reductions but, instead, are marketing expenses that not subject to resale. If WoM promotions were resold, their effect on the retail price is impossible to calculate, since it depends on the value customers place on their time and effort in promoting AT&T's service. If the effect on the retail price were calculable, the associated change in the wholesale price should be calculated using the avoided-cost discount.

II. CASHBACK PROMOTIONS

Q. WHAT IS A CASHBACK PROMOTION?

A. As described in Attachment A to the Stipulations, a cashback promotion is an offer that provides a one-time cash or near-cash incentive for new customers to subscribe to a telecommunications service. For purposes of this discussion, I will assume that the retail telecommunications service in question is residential telephone service and that the effect of the cashback promotion on the retail price of the service is equal to the nominal value of the cashback.[2] The pricing issue in this proceeding is then whether the wholesale price of the promotion is calculated as

- the avoided-cost discount off of the new effective retail price, which is equal to the previous wholesale price less the discounted amount of the cashback (AT&T's position) or
- the previous wholesale price less the full amount of the cashback (the resellers' position).

For convenience, I will call AT&T's method of calculating the promotional

[2] As explained by the Fourth Circuit Court of Appeals in *BellSouth Telecommunications, Inc. v. Sanford*, 494 F.3d 439 (4th Cir. 2007) ("*Sanford*") and at pages 16-17 of my Direct Testimony, the net effect of a cashback promotion on the retail price of the service often is far less than the nominal value of the cashback.

wholesale price as the "discounted-cashback" method and the resellers' method as the "full-cashback" method.

Q. HOW DOES DR. KLEIN ANALYZE THE WHOLESALE PRICE OF THE SERVICE WHEN IT IS SUBJECT TO A CASHBACK PROMOTION?

A. On pp. 9-13 of his Direct Testimony, Dr. Klein asserts that failure to resell a cashback offer would result in a price squeeze [p. 9, line 10 – p. 10, line 16]. He further asserts that: reselling the cashback offer at the full-cashback wholesale price would prevent a price squeeze [p. 10, line 18 – p.11, line 8]; the discounted-cashback method would result in a price squeeze [p. 11, lines 10-20]; and the full-cashback method would leave AT&T indifferent between selling the promotion directly to a customer or indirectly through a reseller [p. 12, line 1 – p. 13, line 5]. On this basis, he recommends use of the full-cashback method for calculating the wholesale price of a cashback promotion.

Q. HOW DOES MR. GILLAN ANALYZE THE WHOLESALE PRICE OF THE SERVICE WHEN IT IS SUBJECT TO A CASHBACK PROMOTION?

A. Mr. Gillan offers two different interpretations of a cashback offer. First, he asserts that the retail cashback is a term or condition of the retail service, and from that assertion, he leaps to the erroneous conclusion that discounting the retail cashback amount by the Commission-approved resale discount rate is a restriction on resale in "violation of Sections 251(c)(4)(B) and 271(c)(2)(B)(xiv) of the Act, as well as Section 51.605(e) of the FCC rules." [Gillan p. 4, line 10 – p. 8, line 8] Second, he claims that the full-cashback method is required in order that AT&T's wholesale prices conform to the FCC's pricing rules for resale. [Gillan p. 9, line 10 – p. 10, line 7]. Specifically, Mr. Gillan claims that

> The cash-back promotion reduces the effective retail rate by $50 (at least for the first month). By providing the full amount of the cash-back promotion to the reseller, the effective wholesale rate is also reduced by $50, thereby restoring the correct wholesale-to-retail rate relationship of $4.81. [Gillan, p. 10, lines 3-7]

For these reasons, Mr. Gillan recommends use of the full-cashback method for calculating the wholesale price of a resold cashback promotion.

Q. DO YOU AGREE WITH THE ANALYSIS AND RECOMMENDATIONS OF DR. KLEIN AND MR. GILLAN?

A. No, and in the remainder of this section of my Rebuttal Testimony, I explain why the Commission should reject these analyses and recommendations.

A. AT&T's Discounted Cashback Method Appropriately Treats Cashback Promotions as Reducing the Retail Price of the Telecommunications Service

Q. AN AT&T $50 CASHBACK PROMOTION LEAVES THE NOMINAL RETAIL PRICE OF THE TELECOMMUNICATIONS SERVICE UNCHANGED AND PROVIDES A $50 CHECK OR GIFT CARD TO QUALIFYING CUSTOMERS WHO REDEEM THE OFFER. FROM AN ECONOMIC PERSPECTIVE, IS IT APPROPRIATE TO TREAT THE $50 CASHBACK PROMOTION AS A ONE-TIME $50 REDUCTION IN THE RETAIL PRICE OF THE TELECOMMUNICATIONS SERVICE?

A. Yes. From an economic perspective, it is appropriate to treat a cashback promotion as reducing the effective price that retail customers pay. Dr. Klein apparently agrees, asserting that

> "[t]he cashback offer functions as a rebate, rather than a direct price discount, ***but the potential effect on the reseller is the same***." [Klein, p. 9, lines 6-7 (emphasis added)]

Mr. Gillan also admits as much when he testifies that "[t]he cash-back promotion ***reduces the effective retail rate*** by $50 (at least for the first month)." [Gillan, p. 10, lines 3-4 (emphasis added)],[3] and he makes the same point in his Table 1, where a $50 cashback promotion provides a one-time $50 reduction in the "effective" retail price of the service. This approach is consistent with the *Sanford* decision that upholds the North Carolina Commission's decision to treat incentives such as a rebate or a gift card as reducing the retail price for a telecommunications service.[4]

Thus, for assessing the economic effect of the promotion on the reseller, we are obliged to consider the effect of the promotion on the retail price of the service.

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[3] Similarly, the acting CEO of one of respondents to this proceeding, dPi, testified before the North Carolina Utilities Commission that when AT&T "issues a cashback promotion, the net effect of that promotion is to reduce the retail price its customers are paying for telephone service." Transcript, In the Matter of: BellSouth Telecommunications, Inc.: Complaint of dPi Teleconnect, LLC, Docket No. 55, Sub 1744 (November 12, 2009) ("*North Carolina Transcript*") at 54. Available at http://ncuc.commerce.state.nc.us/cgi-bin/webview/senddoc.pgm?dispfmt=&itype=Q&authorization=&parm2=6AAAAA53001B&parm3=000128592

[4] *Sanford*, 449-50.

Q. IS THERE A SIMPLE EXAMPLE THAT SHOWS WHY A CASHBACK PROMOTION SHOULD BE TREATED AS A RETAIL PRICE REDUCTION?

A. Yes. The Fourth Circuit provided such an example at pages 450-451 of its *Sanford* decision. In that example, BellSouth initially offers retail residential telephone service for $20 per month and resells it at $16 per month, consistent with a hypothetical 20 percent avoided-cost discount. Subsequently, BellSouth raises the retail price to $120 per month but sends its customers a $100 cashback check every month, so that the retail price is effectively unchanged. If the cashback promotion is treated as a price reduction, the new effective retail price is $20 per month, the wholesale price is $16 per month, and nothing of competitive significance has changed. On the other hand, if the cashback check is ignored, the recurring wholesale price becomes $96 per month (a 20 percent discount off of the retail price of $120) and the reseller cannot compete against an effective retail price of $20. The Court used this example in affirming the North Carolina Commission's decision to account for the effect of the promotion on the retail price of the service in calculating the wholesale price because not to do so would essentially eviscerate BellSouth's resale obligations.

Q. USING THE COURT'S EXAMPLE, HOW WOULD THE TWO SIDES IN THIS PROCEEDING APPLY A RECURRING RETAIL CASHBACK PROMOTION TO RESELLERS?

A. Under the arguments advanced by Mr. Gillan and Mr. Klein, the resellers would claim that they are entitled to the full $100 recurring promotion on a $96 recurring wholesale price. The absurd result would be that AT&T would end up paying resellers $4 per month ($120 retail price minus the wholesale discount of 20 percent minus the full $100 promotion) as AT&T's "compensation" for providing the underlying telecommunications service to the resellers' end users.

Conversely, if the AT&T approach is applied, both the recurring charge and promotion are subject to the same wholesale discount. Here, the resellers would pay a $96 wholesale price but receive an $80 bill credit ($100 promotion less the 20 percent wholesale discount) resulting in a net wholesale price of $16 per month.

In the Court's example, the effective retail price is unchanged by the promotion, so that the effective wholesale price should also be unchanged. Under AT&T's approach, the wholesale price remains unchanged at $16, a constant 20 percent discount off of the unchanged retail price. Under the resellers' approach, however, the wholesale price would change from $16 to -$4 even though the effective retail price remained the same. The result makes no economic sense and, as described below, is contradicted by long-standing Commission decisions and by the relevant ICAs under which wholesale services are provided to resellers.

Q. MR. GILLAN ASSERTS [P. 6, LINES 15-16] THAT THE FCC'S RULES

"PLACE THE RESELLER IN THE SHOES OF THE RETAIL CUSTOMER" SO THAT THE RESELLER IS ENTITLED TO THE FULL AMOUNT OF ANY CASHBACK PROMOTION. DO YOU AGREE?

A. No. The Telecommunications Act of 1996 ("the 96 Act") and the FCC rules cited by Mr. Gillan do not require that *every* characteristic and condition of a retail service must be provided to the reseller. In particular, those rules make an exception for the *price* of the service: resellers are entitled to purchase telecommunications services offered at retail at wholesale prices that have been calculated consistently with the FCC's avoided cost methodology [47 C.F.R. § 51.603(a)]. Thus, as I explained at pages 14-16 of my Direct Testimony, a change in the price of the retail service does not require an equal change in the price of the wholesale service. Instead, when the retail price an end user pays for a service increases, the wholesale price a reseller pays for that service increases by a lesser (but proportionate) amount. Similarly, when the retail price an end user pays for a service decreases, the wholesale price a reseller pays for that service decreases by a lesser (but proportionate) amount. Contrary to Mr. Gillan's assertions, therefore, resellers are *not* entitled to the full amount of any cashback promotion.

B. The Wholesale Price is a Fixed Percentage Discount Off of the Retail Price, not a Fixed Dollar Amount

Q. DO THIS COMMISSION'S DECISIONS REQUIRE THAT AT&T FULLY PASS THROUGH ANY REDUCTION OR INCREASE IN THE RETAIL PRICE

DOLLAR-FOR-DOLLAR IN THE WHOLESALE PRICE CHARGED TO RESELLERS?

A. No. In South Carolina, the wholesale price of a service is calculated as a 14.8 percent discount off of the retail price.[5]

Q. DO THE APPLICABLE ICAS REQUIRE THAT AT&T FULLY PASS THROUGH ANY REDUCTION OR INCREASE IN THE RETAIL PRICE DOLLAR-FOR-DOLLAR IN THE WHOLESALE PRICE CHARGED TO RESELLERS?

A. No. The Commission-approved 14.8 percent discount is incorporated into the parties' Commission-approved ICAs. The 2009 ICA between AT&T South Carolina and Affordable Phone Services, for example, provides that "[t]he Telecommunications Services available for purchase by [Affordable] for the purposes of resale to [Affordable's] End Users shall be available at BellSouth's tariffed rates less the discount set forth in Exhibit E to this Agreement," which has "been determined by the applicable Commission."[6] The ICAs of the other reseller parties to this Docket contain similar language.[7]

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[5] Order on Arbitration, *In Re: Petition of AT&T Communications of the Southern States, Inc. for Arbitration of an Interconnection Agreement with BellSouth Telecommunications, Inc.,* Order No. 97-189 in Docket No. 96-358-C ("Resale Discount Order") at 14 (March 10, 1997).

[6] 2009 Affordable Phone Services ICA, Attachment 1, §§1.1 to 1.2. Page 8 of Exhibit E sets forth the 14.8 percent resale discount rate established by this Commission.

[7] *See also,* 2007 DialTone & More ICA, Attachment 1, §§1.1-1.2 and Exhibit D at 2 of 2; 2007 dPi ICA, Attachment 1, §§1.1-1.2 and Exhibit C at 8 of 9; 2006 Image Access ICA, Attachment 1, §§1.1-1.2 and Exhibit D at 8 of 9; 2010 OneTone ICA,
(continued...)

Q. IN LIGHT OF THIS ICA, HOW DOES A CHANGE IN THE RETAIL PRICE OF A TELECOMMUNICATIONS SERVICE AFFECT THE WHOLESALE PRICE OF THAT SERVICE?

A. Simple arithmetic shows that a $1 reduction or increase in the retail price of a retail telecommunications service requires an $0.852 ($1.0 – $0.148) reduction or increase in the wholesale price of the service. Thus, when a cashback promotion is treated as a $1 reduction in the retail price, the wholesale price of the service falls by $0.852, not by the full $1 of the cashback.

Dr. Klein recognizes this fact in his explanation of how wholesale prices are determined:

> In practice, the states determined these avoided costs as a percentage of retail revenues and applied this "percentage discount" to each retail rate to arrive at the wholesale rate. [Klein, p. 6, lines 16-18]

Q. DOES DR. KLEIN PROPOSE TO CALCULATE THE WHOLESALE PRICE OF SERVICE THAT IS SUBJECT TO A CASHBACK PROMOTION IN THIS MANNER?

A. No. Instead, Dr. Klein (like Mr. Gillan) proposes a new calculation by which the wholesale price of the service is calculated as the new "effective" retail price of the service minus a fixed number for avoided costs. Under this new

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(...continued)

Attachment 1, §§1.1 to 1.2 and Exhibit D at 8 of 9.

calculation, the fixed number for avoided costs is calculated as the avoided-cost discount off of the "regular" price for the retail service.

Q. WHY DO YOU REFER TO THIS AS A "NEW" CALCULATION?

A. Because it is different than the calculations required by the Commission's Orders and the parties' interconnection agreements, and I am not aware of the FCC or any state Commission using such a calculation to determine wholesale prices.

Q. IS DR. KLEIN'S NEW CALCULATION CORRECT?

A. No. If the cashback is treated as a reduction in the retail price of the service (as both Dr. Klein and Mr. Gillan recommend), it is appropriate for AT&T to account for the cashback in its wholesale price calculation. The 96 Act provides how this is to be accomplished:

> For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of <u>retail rates charged to subscribers for the telecommunications service requested</u>, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier. [§ 252(d)(3), emphasis added]

It does not say "regular" retail rates or "undiscounted" retail rates. Rather, it ties the wholesale price of the service being resold (here, the promotion) to the retail price <u>actually charged</u> for the service being resold. This fact was noted in the *Sanford Decision* cited above:

> The NC Commission concluded that when such incentives are offered, the nominal tariff (the charge that appears on the subscriber's bill) is not the "retail rate charged to subscribers" under § 252(d)(3) because the nominal tariff does not reflect the value of the incentives. Retail subscribers are, in fact, charged *less* than

> the tariff rate because they receive the added value of the incentives.

That same logic — applied to the FCC's pricing standard in § 51.607 of its Rules[8] — means that "the rate for the telecommunications service" is interpreted as the effective rate, including the effect of the retail promotion. That logic also applies to "the portion of the retail prices for those services" in ¶ 908 of the FCC's *First Report and Order,*[9] because "those services" are the promotions, and the retail prices for the promotions obviously include the effect of the promotional discounts. Finally, in ¶ 916 of the *First Report and Order*, the FCC presumes (without requiring) that the avoided cost discount pricing rule would be implemented by use of a *rate* (*e.g.*, 14.8 percent of the retail price) rather than by subtracting a dollar amount of avoided costs for a particular service from its retail price:

> 916. We neither prohibit nor require use of a single, uniform discount <u>rate</u> for all of an incumbent LEC's services. We recognize that a uniform <u>rate</u> is simple to apply, and avoids the need to allocate avoided costs among services. Therefore, our default wholesale discount is to be applied uniformly. On the other hand, we also agree with parties who observe that avoided costs may, in fact, vary among services. Accordingly, we allow a state to approve nonuniform wholesale discount <u>rates</u>, as long as those

[8] This rule states that "[t]he wholesale rate that an incumbent LEC may charge for a telecommunications service provided for resale to other telecommunications carriers shall equal <u>the rate for the telecommunications service</u>, less avoided retail costs, as described in section 51.609." [emphasis added).

[9] "The statutory pricing standard for wholesale rates requires state commissions to (1) identify what marketing, billing, collection, and other costs will be avoided by incumbent LECs when they provide services at wholesale; and (2) calculate the portion of the <u>retail prices for those services</u> that is attributable to the avoided costs." [emphasis added]

> rates are set on the basis of an avoided cost study that includes a demonstration of the percentage of avoided costs that is attributable to each service or group of services. [emphasis added]

Indeed, the FCC's default rates, which it determined to be consistent with the 96 Act, were all implemented by means of a percentage discount off of the retail price, not as a dollar value of avoided costs for each service. To my knowledge, nearly every state uses a percentage discount off of the retail price to calculate the wholesale price; no state of which I am aware uses the new method proposed by Dr. Klein and Mr. Gillan.

Q. IN HIS TABLE 1, MR. GILLAN SHOWS THAT THE FULL-CASHBACK METHOD THAT HE AND DR. KLEIN RECOMMEND RESULTS IN THE SAME ABSOLUTE DOLLAR MARGIN BETWEEN THE RETAIL AND WHOLESALE PRICES BEFORE AND AFTER THE CASHBACK PROMOTION. IS THIS DEMONSTRATION CORRECT?

A. No. The arithmetic is correct but the conclusion is wrong. Mr. Gillan says that

> [b]y providing the full amount of the cash-back promotion to the reseller, the effective wholesale rate is also reduced by $50, thereby restoring the correct wholesale-to retail rate relationship of $4.81. [Gillan p. 10, lines 4-7]

Mr. Gillan's error is in asserting that the "correct" wholesale-to-retail price relationship is equal to $4.81.

Mr. Gillan earlier states that

> FCC rules require that the wholesale discount be the product of a cost-study approved by the State Commission. AT&T may only deviate from the results of an approved study if a State

> Commission reviews and approves a different avoided-cost study that satisfies the full requirements of federal rules. As the following [Table 1] illustrates, the only way to maintain the wholesale-to-retail rate relationship consistent with the approved study is to pass through the full value of any cash-back promotion. [Gillan, p. 9, lines 12-18, footnote omitted]

On the contrary, the avoided-cost study approved by this Commission (its Resale Discount Order) that satisfies the full requirements of federal rules found that the "correct" wholesale-to-retail price relationship was based on the uniform resale discount rate of 14.8 *percent*, not on the fixed dollar difference asserted by Mr. Gillan. That is, the Commission-approved wholesale-to-retail price relationship was that the wholesale price was a 14.8 percent discount off of the retail price, calculated by multiplying the retail price by 0.852 (1.0 - 0.148). The dollar difference between the retail and wholesale prices would thus change whenever the retail price changed, in contrast to Mr. Gillan's assertion that it would remain at some fixed dollar amount forever.

Q. IN TABLE 1 THAT ILLUSTRATES HIS PROPOSED FULL-CASHBACK METHOD, MR. GILLAN SUGGESTS THAT $4.81 IS THE FIXED DOLLAR AMOUNT OF THE AVOIDED COSTS OF A "COMPLETE CHOICE" RETAIL SERVICE PRICED AT $32.50. HAS THIS COMMISSION EVER DETERMINED A FIXED-DOLLAR "AVOIDED COST" OF A "COMPLETE CHOICE" OFFERING?

A. No. The Commission's 14.8 percent avoided-cost discount was measured by dividing the avoided costs for <u>all</u> retail telecommunications services by retail revenue from all telecommunications services.[10] For the reasons discussed in my Direct Testimony [p. 9, line 15 – p. 10, line 2], that percentage cannot be applied to the retail price of any particular service to calculate an economically meaningful measure of the avoided cost from reselling that service. Indeed, nothing suggests that the Complete Choice retail service (Mr. Gillan's example in Table 1) today is the same as it was in 1997 when the Commission approved the avoided-cost wholesale discount. And even if it were, the 14.8 percent figure is an average across all services. It cannot be used to determine a dollar amount of avoided costs for any particular service any more than the average height of adult males could be used to determine the actual height of the center for the Boston Celtics.

Q. BUT USING A 14.8 PERCENT AVOIDED-COST DISCOUNT MEANS THAT THE DOLLAR VALUE OF AVOIDED COST CHANGES WHEN THE RETAIL PRICE CHANGES. CAN THAT BE RIGHT?

A. Yes. The total dollar value of avoided costs across all retail services was calculated in the Commission's 1997 Resale Discount Order, and no one would think that those costs would remain unchanged over time. However, it would have been an administrative nightmare to recalculate those avoided costs every time a retail price changed. Accordingly, the FCC and nearly every state Commission adopted the far better "percentage discount" method which

[10] *See*, for example Klein, p.6, lines 16-18.

assumed that regulation and competition would cause retail prices and costs to move in approximately the same proportion over time, so that a change in retail prices reflects (approximately) a proportional change in retail service costs. In this case, using a fixed avoided-cost percentage discount (such as the Commission's 14.8 percent) is exactly correct, in the sense that the difference between the retail and wholesale prices would always equal the dollar value of avoided costs.

The assumption that retail prices and costs move proportionally over time is obviously only approximately correct. However, it is certainly more accurate than the implicit assumption in Mr. Gillan's Table 1 (and in Dr. Klein's price squeeze equations (pp. 9-11)) that the dollar value of avoided costs never changes over time.

Q. ARE THERE OTHER CONSEQUENCES OF USING THE RESELLERS' FULL-CASHBACK METHOD RATHER THAN AT&T'S DISCOUNTED-CASHBACK METHOD TO CALCULATE THE WHOLESALE PRICE FOR A CASHBACK PROMOTION?

A. Yes. Consider again the Fourth Circuit's hypothetical example from the *Sanford* case outlined above. With a retail price of $120 and a hypothetical resale discount rate of 20 percent, the reseller would pay $96 per month. If the full $100 monthly cashback were flowed through to the reseller, the reseller would *receive* (not pay) $4 per month from BellSouth to serve the resale customer. Meanwhile, BellSouth's effective retail price after the promotion is unchanged at $20 per month. Thus the margin between the retail and wholesale price would have increased from $4 per month before the promotion to $24 per month under the promotion.

Recall that the point of the Fourth Circuit's example is that a retail price increase that is offset by a cashback offering of the same amount should leave everything exactly the same. Table A shows that AT&T's discounted cashback method fulfills this expectation and the resellers' full-cashback method violates it. The regular effective retail and wholesale prices are $20 and $16 respectively, and these prices are unchanged under the promotion, using AT&T's discounted-cashback method. However, the resellers' full-cashback method reduces the effective wholesale price from $16 to -$4, and the resellers' margin (the difference between the retail and wholesale prices) increases from $4 to $24.

Table A
Fourth Circuit Court of Appeals' Example
Retail Price Increase Offset by Discount Should Make No Difference

	Regular Recurring Monthly Price	Discounted Cashback (AT&T Method) Promotional Recurring Monthly Price	Full Cashback (CLEC Method) Promotional Recurring Monthly Price
Retail Price	$20	$120	$120
Wholesale Price	$16	$96	$96
Cashback - Retail	$0	$100	$100
Cashback - Wholesale	$0	$80	$100
Effective Retail Price	$20	$20	$20
Effective Wholesale Price	$16	$16	-$4
Margin	$4	$4	$24
Avoided-Cost Discount	20.00%		
Monthly Cashback	$100		

C. Applying the Commission's Avoided-Cost Discount does not Constitute a Price Squeeze

Q. WHAT IS A PRICE SQUEEZE IN ECONOMICS?

A. In economic theory, a price squeeze can — but does not necessarily — occur when a vertically-integrated firm prices a wholesale service so high that an otherwise efficient competitor (that must purchase that wholesale service in order to compete) cannot compete profitably against the vertically-integrated firm's retail price. In other words, a price squeeze can occur when the margin between the wholesale and retail prices is too small to permit competition from otherwise efficient firms.[11] This is essentially the definition of a price squeeze outlined in Dr. Klein's testimony [p. 7, lines 13-21].

Q. WHAT PUBLIC POLICY OBJECTIVES ARE AFFECTED BY A PRICE SQUEEZE?

A. In this context, there are essentially two public policy objectives that are potentially impacted by a price squeeze. First, the 96 Act is expressly designed to "open[ ] the local exchange and exchange access markets to competitive entry."[12] One of the ways it accomplishes this is by requiring incumbent local exchange carriers to sell certain services to competitive local exchange carriers for those carriers to resell to end users. If the wholesale prices charged to competitive local exchange carriers were too high for an efficient reseller to compete against the retail price, that situation could be viewed as a type of price squeeze. As explained below, in the context of the resale issues presented in this proceeding, Congress determined that the objective of facilitating resale is satisfied when wholesale prices are determined on the basis of retail prices, "excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided" by AT&T. *See* 47 U.S.C. §252(e)(3).

[11] See Alfred E. Kahn and William E. Taylor, "Comment on Pricing of Inputs Sold to Competitors," *Yale Journal on Regulation*, Vol. 11, Issue 1, 1994, pp. 225-240.

[12] *First Report and Order* at ¶ 3.

A second public policy objective is to prevent monopolization of markets by proscribing anticompetitive acts that would allow a firm to achieve market power. As explained below, this objective is embodied in Section 2 of the Sherman Act ("Section 2"), and there is considerable case law applying Section 2 to alleged price squeezes in telecommunications and other markets.[13]

Q. WHICH OF THESE TWO POLICY OBJECTIVES DOES DR. KLEIN'S TESTIMONY ALLEGING A "PRICE SQUEEZE" ADDRESS?

A. He does not say explicitly. His testimony, however, interprets what he perceives as an inadequate margin under the FCC's resale rules as a price squeeze [Klein, p. 8, lines 1-19]. I address both the 96 Act and Section 2 contexts below, and to avoid ambiguity, I distinguish between these notions of price squeeze by explicit reference to either the 96 Act or Section 2.

1. AT&T's Method Does Not Violate the Resale Rules in the 96 Act

Q. DOES AT&T'S DISCOUNTED-CASHBACK METHOD OF CALCULATING THE WHOLESALE PRICE CONSTITUTE A PRICE SQUEEZE IN VIOLATION OF THE 96 ACT?

A. No. Congress expressly determined that "a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof

[13] Good summaries of this history can be found in Town of Concord v. Boston Ed. Co., 915 F.2d 17 (1st Cir. 1990) and Pacific Bell Telephone Co. v. linkLine

(continued...)

attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier." *See* 47 U.S.C. §252(d)(3). The FCC's wholesale pricing rules as implemented by this Commission appropriately establish the wholesale price as an avoided-cost discount off of the retail price, so that an otherwise efficient resale competitor can compete against AT&T's retail price. Whether that required margin is an unchanging absolute dollar amount — as proposed by Dr. Klein — or a percentage of the retail price — as permitted by the FCC and implemented by this Commission — is immaterial for the purpose of assessing Dr. Klein's price squeeze claim. AT&T's resale obligation derives from the 96 Act and its implementation, and because the FCC and this Commission determined that a 14.8 percent margin is sufficient to allow efficient resellers to compete, retail and wholesale prices calculated consistently with that formula cannot violate the 96 Act and are not anticompetitive.

Q. ARE THERE OTHER INDICATIONS THAT AT&T'S DISCOUNTED-CASHBACK METHOD OF CALCULATING THE WHOLESALE PRICE DOES NOT CONSTITUTE A PRICE SQUEEZE IN VIOLATION OF THE 96 ACT?

A. Yes. Under Dr. Klein's interpretation of a price squeeze, any time AT&T reduced its retail price for a service and simultaneously reduced its wholesale price using the Commission-approved avoided-cost discount, it would engage

(...continued)

Communications, Inc., 129 S. Ct. 1109 (Feb. 25, 2009) ("*linkLine*").

in a price squeeze under the 96 Act.[14] This surely was not the intention of the FCC's rules or this Commission's resale decision; indeed, Dr. Klein acknowledges [p. 8, lines 7-8] that the FCC "took actions to prevent such a price squeeze and its detrimental effect on resale competition." From this statement, it is difficult to understand how Dr. Klein can find a price squeeze in violation of the 96 Act from the ordinary application of the FCC's resale pricing rules.

Q. SUPPOSE RETAIL PRICES CHANGE IN PROPORTION TO COSTS, AS SUGGESTED ABOVE. USING DR. KLEIN'S DEFINITION AND HIS ALGEBRA, WOULD AT&T'S DISCOUNTED-CASHBACK METHOD RESULT IN A PRICE SQUEEZE IN VIOLATION OF THE 96 ACT?

A. No. Dr. Klein's algebra ignores the fact that retail prices and costs are related. Assume retail prices fell by 10 percent, and costs fell by the same percentage. Under AT&T's discounted-cashback method the wholesale price would fall by 10 percent, and the margin — the difference between the new retail and wholesale prices — would also fall by 10 percent. But by assumption AT&T's costs — including the avoided costs of resale — would also fall by 10 percent. Thus, If the reseller's margin — the difference between AT&T's retail and

[14] In South Carolina, the wholesale price is always 85.2 percent of the retail price. Thus, a $1.00 reduction in the retail price would reduce the wholesale price by only $0.85, not by the full $1.00. If the difference between the retail and wholesale prices were initially equal to the avoided cost, say $10, that difference would be only $9.85 after the $1 retail price reduction and $0.85 wholesale price reduction.

wholesale prices — initially equaled AT&T's avoided costs, then the new margin would equal the new avoided costs. Under the resellers' method, however, the margin would remain the same in dollar value and would therefore exceed the new level of avoided costs as well as the Commission-approved resale discount proportion. In other words, the resellers' method would determine wholesale rates by subtracting *more than* the "avoided costs" from the retail price, which clearly is contrary to Section 252(d)(3) of the 96 Act.

2. AT&T's Method Does Not Violate Section 2

Q. DOES AT&T'S DISCOUNTED-CASHBACK METHOD OF CALCULATING THE WHOLESALE PRICE CONSTITUTE A PRICE SQUEEZE IN VIOLATION OF SECTION 2?

A. No. Dr. Klein's algebra only addresses the adequacy of the retail-wholesale price margin. But recent U.S. Supreme Court law makes clear that, absent an antitrust duty to provide the service at wholesale in the first place,[15] the vertically-integrated firm's retail price must be predatory for it to be proscribed under Section 2. In other words, AT&T's retail prices would need to be below cost, and AT&T would need a reasonable opportunity to recoup the losses it incurs at present in selling below cost with supra-competitive pricing in the future in a less-competitive market.[16] Further, unless the service sold at

[15] Here, there is no antitrust duty for AT&T to sell services at wholesale for competitive local exchange carriers to resell; rather, that duty stems solely from the 96 Act.

[16] These conditions are outlined in the recent Supreme Court decision in *linkLine*.

wholesale were an essential input for a retail competitor, there is no reason to believe that the pricing of that input would truly matter to the overall state of competition in the market.

Q. ARE THESE CONDITIONS FOR A SECTION 2 PRICE SQUEEZE – AN ESSENTIAL INPUT AND AN ABILITY TO RECOUP LOST PROFITS – MET IN THE CURRENT CASE?

A. No. There is no suggestion that AT&T's retail prices are below cost, or that, even if they were, that AT&T would have any prospect of driving competitors from the market and later recouping current losses through future supra-competitive pricing. Providing residential local telecommunications services in South Carolina is a very competitive business, and AT&T faces competition from several significant facilities-based competitors. Thus, AT&T cannot become a monopolist by pricing retail services below cost, or squeezing resale competitors from the market.

As measured by customers, the vast majority of AT&T's competitors for residential local exchange service — cable companies, for example — use their own facilities to supply their customers. Two consequences follow from this fact. First, AT&T's residential local telecommunications services cannot be essential inputs for retail competitors because competitors can and do provide residential telephone services without using those AT&T facilities. Second, a price squeeze that reduced the margin between AT&T's retail and wholesale prices would have no effect on such facilities-based carriers because they do not resell AT&T's services. Thus, even if the difference between AT&T's retail and wholesale prices were less than its avoided cost from resale, that margin would do nothing to drive facilities-based competitors like cable companies from the market, and therefore, there would be no ability to recoup lost profits in the future through higher prices. For all these reasons, such prices would not constitute a price squeeze under Section 2.

3. AT&T's Method is not Anticompetitive

Q. ARE THERE OTHER INDICATIONS THAT THE AT&T DISCOUNTED-CASHBACK METHOD DOES NOT REDUCE COMPETITION IN THE MARKET?

A. Yes. Dr. Klein asserts [p. 9, lines 15-18] that

> In order to sell the service in competition with AT&T, the reseller must match [AT&T's] cash back offer in some form...

and concludes that "This is a classic price squeeze."

In addition to the reasons I have already discussed, the difficulty with labeling this situation an anticompetitive price squeeze is that there is no evidence in the case that AT&T and the resellers compete to any significant degree for customers. To the contrary, the acting CEO for one of the resellers in this proceeding — dPi — testified recently in Georgia that "essentially every single one of dPi's new customers is someone who was formerly a customer of BellSouth or another provider and who left after getting into trouble over their phone bill," and in North Carolina he testified that dPi serves "a prepaid niche that's not served by [AT&T] and it's not served by . . . any postpaid provider."[17] Based on publicly-available information, it appears that the same is true of other resellers in this proceeding.[18]

Q. DO THE PRICES THESE RESELLERS CHARGE THEIR END USERS FOR SERVICE IN SOUTH CAROLINA SUGGEST THAT THESE RESELLERS COMPETE WITH AT&T TO ANY SIGNIFICANT DEGREE FOR CUSTOMERS?

A. No. To the contrary, the publicly-available information about the prices prepaid resellers charge in South Carolina shows that they do not compete with AT&T for customers. Instead, they compete with one another to serve customers — largely low-income, credit-challenged customers of prepaid services — who do not (or cannot) choose the postpaid services of AT&T or other facilities-based carriers.

Table B shows prices for residential local exchange service in Columbia, South Carolina as offered on Internet websites by AT&T and the resellers in this proceeding.[19] For example, customers choosing between AT&T and dPI in

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[17] Direct Testimony of Tom O'Roark, Georgia Public Service Commission (Docket No. 21849-U (O'Roark Testimony) at 15. *North Carolina Transcript* at 59.

[18] I do not address Tennessee Telephone in this testimony in light of its filing for bankruptcy.

[19] Table B lists the carriers in this proceeding with websites that provided prices for residential, non-governmental assistance customers.

South Carolina must pay 148 percent more for dPI's basic service or 57 percent more for its premium package than for AT&T's approximately comparable services. It seems exceedingly unlikely that dPI would lose customers for its $36.95 per month service to AT&T's $23 service if it failed to match an AT&T cashback promotion. In South Carolina, dPI's retail price is evidently not constrained by the retail price charged by AT&T, and Dr. Klein's theoretical assertion that "the reseller must match [AT&T's] cash back offer" has no application in this market.

In this market, the margin that is relevant for the reseller is not the margin between AT&T's retail and wholesale prices because the resellers' retail prices are far above AT&T's retail prices. Rather, the relevant margin is the difference between the reseller's retail price and its cost (of which AT&T's wholesale price is a component). Under AT&T's discounted-cashback method, the reseller's effective wholesale price falls when AT&T offers a cashback promotion, and the relevant margin for the reseller *increases* not decreases.

Table B
South Carolina 29223

AT&T		
Primary Residential Line	unlimited local, no features	$16.14
Complete Choice Basic	unlimited local, 2 features	$23.00
Complete Choice Enhanced	unlimited local, 13 calling features	$26.00
Complete Choice Enhanced	unlimited local, 13 calling features, LD plan	$31.00
All Distance	unlimited local and LD, 13 calling features	$40.00
dPI		
"Basic"	unlimited local, no features	$39.99
"Advantage" Package	unlimited local, 2 features	$36.95
Premier Select 9	unlimited local, 9 features, 2000 LD	$62.99
OneTone		
	unlimited local, 2 features; 100 LD	$34.00
	unlimited local, 2 features, 2000 LD	$45.00
	unlimited local, 6 features, 2000 LD	$55.00
	unlimited local, 6 features, 7500 LD	$60.00
Dialtone & More		
Non-Lifeline Plan	unlimited local, 60 LD	$33.49
Image Access d/b/a NewPhone		
Basic	unlimited local, no features	$39.95
Premium	unlimited local, 4 features	$49.95

http://www.bellsouth.com/consumer/triplechoice/index.html?state=SC&city=Columbia
http://bellsouth.com/consumer/local/index.html?customer=newCustomer

https://secure.dpiteleconnect.com/phone.mgmt/account_setup/select_package.aspx
http://www.1tone.net/index-2.html
http://www.dtmtel.com/new_order/order.php
http://www.newphone.com/
http://www.homephoneforfree.com/index.html

D. AT&T is not Indifferent Between Serving Retail and Wholesale Customers

Q. DR. KLEIN ASSERTS [P. 12, LINE 1 – P. 13, LINE 5] THAT THE FULL CASHBACK METHOD IS "FAIR" TO AT&T BECAUSE "THE NET REVENUE FOR AT&T FROM A RETAIL SALE WITH CASH BACK IS EQUAL TO THE NET REVENUE AT&T RECEIVES FROM A WHOLESALE SALE WITH CASH BACK." DO YOU AGREE?

A. No, Dr. Klein misinterprets his theoretical equations. Nothing in the 96 Act implies that AT&T should be indifferent between selling through retail and wholesale channels: if that had been Congress' goal, the 96 Act would have created competitors but not competition and consumers would receive no benefits from additional competition.

There are three main reasons why efficient resale competition as outlined in the 96 Act need not (and does not) leave AT&T indifferent between serving retail and wholesale customers. First, nothing in theory or in practice suggests that the net revenues from residential local exchange service are the only revenues to consider. Even if these resellers actually did compete with AT&T for customers, AT&T would have many more opportunities to sell additional services (such as Internet and video services) to the retail customer than to the resale customer. Nothing in the 96 Act suggests that AT&T should view the opportunity to sell these additional service to its retail customers with "indifference."

Second, it is not correct that AT&T actually avoids costs equal to 14.8 percent of its current retail price when it resells a given local exchange service. The 14.8 percent was measured across all retail services and avoided costs for basic exchange services — even if they could be calculated — would not be equal to that average. In addition, the dollar value of avoided costs has surely changed over time — a change that is ignored in Dr. Klein's algebra.

Third, Dr. Klein's theoretical conclusion assumes the reseller "wins" its end-user customer from a provider that is not AT&T and that is not a reseller of AT&T's service. Based on that assumption, Dr. Klein concludes that paying the full cashback amount to the end user or to the reseller would leave AT&T in the same net-revenue position.[20] Dr. Klein's conclusion ignores the fact that many of the resellers' customers that would generate a wholesale cashback credit to the reseller would be either AT&T customers (who, as dPi's acting CEO put it, "left after getting into trouble over their phone bill,") or customers of another reseller of AT&T service who churn from one reseller to another. In the first case, AT&T's net revenue is obviously higher if it continues to serve its customers at retail (without incurring a cashback obligation) rather than paying a cashback credit to a reseller to serve the same customer at wholesale. In the second case, AT&T's net revenue obviously falls when such customers are churned from one AT&T reseller to another, leaving monthly wholesale revenue unchanged but generating cashback credits for the reseller at each transaction. If Dr. Klein's indifference principle were important, then AT&T should only give resellers one-time credits for promotions when the end-user customer is new to AT&T: *i.e.*, neither a current AT&T retail or wholesale customer.

Q. IS IT COMMON FOR END USERS TO CHURN FROM ONE PREPAID

[20] Ignoring the fact that historical avoided cost for a particular service likely differs from the avoided-cost percentage of the current retail price.

RESELLER TO ANOTHER?

A. Yes. In recent proceedings before the North Carolina Commission, dPi's acting CEO testified that the customer turnover for a prepaid company like itself "ranges from a low of 10 percent [churn] every month to a high of 30 percent [churn]."[21] Combined with the fact that "essentially every single one of dPi's new customers is someone who was formerly a customer of BellSouth or another provider and who left after getting into trouble over their phone bill," the volume of customer churn among resellers must be considerable.[22]

III. THE LINE CONNECTION CHARGE WAIVER PROMOTION

Q. HOW DOES DR. KLEIN PROPOSE TO CALCULATE THE WHOLESALE PRICE OF LINE CONNECTION UNDER THE LCCW?

A. In general, Dr. Klein's calculation of the wholesale price for the LCCW promotion follows the same method as he proposed for cashback promotions. The wholesale price of the service is calculated as the new "effective" retail price of the service minus a fixed number for avoided costs, calculated as the avoided-cost discount off of the "regular" price for the retail service.

Q. IS THIS CALCULATION CORRECT?

A. No, for the same reasons it was incorrect for the cashback promotion. Dr. Klein [p. 15, lines 7-13] attempts to distinguish between the "regular" retail price and

[21] *North Carolina Transcript* at 112.

[22] O'Roark Testimony at 15; cited above at footnote 17.

the "effective" retail price for calculating the wholesale price.

Q. IS HIS DISTINCTION VALID?

A. No. Dr. Klein first asserts [p. 15, lines 9-10] that because "the regular retail rate for line connection has not changed, so neither has the avoided cost." This claim presumes that the only way that cost pressures are reflected in prices is through changes in tariffed prices rather than through discounts and promotions. In competitive markets, however, competitive pressures — both cost and demand — are certainly reflected in discounts and promotions. For example, automobile sticker prices change slowly in response to changes in demand and cost conditions, while price discounts, cashback offers and 0 percent financing change far more frequently. The same is true of the competitive telecommunications market in South Carolina: while AT&T's "sticker price" as reflected in its South Carolina General Exchange Guidebook may change slowly, its promotional offerings change far more frequently in response to competitive conditions.

Second, Dr. Klein asserts [p. 15, lines 12-13] that "[i]f AT&T were to permanently eliminate the line connection charge, only then would the avoided cost disappear." Read literally, the statement seems to be backwards: cost do not disappear because prices change. What Dr. Klein appears to mean is that the avoided cost used to calculate the wholesale price should be based on the "permanent" line connection charge, not the discounted retail price of $0.

As cited above, both of these assertions are inconsistent with economic theory — that recognizes that discounts and promotions reflect the same type of cost and demand pressures as tariffed prices — and with the 96 Act, the FCC's *First Report and Order* and associated rules and the findings of the North Carolina Commission and the *Sanford Decision*.

IV. THE WORD-OF-MOUTH PROMOTION

Q. SHOULD AT&T BE REQUIRED TO RESELL THE WOM?

A. No. As I explained in my direct testimony [p. 34, line 11 – p. 35, line 12], the WoM promotion is a marketing program not a price reduction, and AT&T is not obligated to resell that program in any form to a reseller. Dr. Klein's only argument for mandatory resale of the program is that it provides an (unquantified) expected benefit to AT&T retail customers. That fact does not mean that the program must be resold: AT&T and its resellers are supposed to compete on the basis of marketing and customer services, as explained by Dr. Klein:

> Q. What are the benefits of resale competition?
>
> A. If resellers are to successfully compete with ILECs, they must offer consumers something that the ILECs do not. Since the functions avoided by the ILECs in selling to resellers involve marketing, consumer service, billing and collection, etc., the resellers would have to provide these functions at lower cost, or in higher quality than the ILECs do. If the resellers are able to do this, then consumers benefit from lower prices, or better service, or both. [p. 6, line 20 – p. 7 line 3].

Certainly if AT&T and its resellers are expected to compete by means of marketing and consumer services, AT&T cannot be required to provide marketing and consumer services to resellers at an avoided cost discount.

Suppose AT&T hired a group of college students to hand out fliers at a local mall to promote its local service, and it compensated the students based on the number of new customers who took advantage of the offer. Nothing in the resale obligations in the 96 Act would compel AT&T to pay resellers to conduct a similar sales effort. Indeed, the competition that occurs between AT&T and its resellers takes place precisely in the marketing and customer service functions so that "resale" of marketing expenses would undermine the very competition envisioned in the 96 Act. And, it makes no difference in this example whether the college student is a customer of AT&T's local service. The students are compensated for selling (not buying) AT&T's service, and the same is true for AT&T's WoM sales program. Thus, even if a marketing program like WoM confers some expected benefit on AT&T's retail customers, that fact does not imply that the program must be resold.

Q. ASSUME FOR THE REMAINDER OF THIS SECTION OF YOUR TESTIMONY THAT THE WOM PROMOTION MUST BE RESOLD. HOW DOES DR. KLEIN PROPOSE THAT THIS RESALE BE IMPLEMENTED?

A. It appears that Dr. Klein wants to reduce the wholesale price for residential local service to all customers to reflect the expected benefit that customers receive from *the option* to make use of the WoM promotion:

> … the effect [on the retail price] involves the customers who are eligible to register for the referral program, <u>not for the new customers gained as a result of the referral</u>. A customer who is eligible for the referral program expects to pay a net retail price that is lower by the amount of the expected referral benefits. [p. 15, lines 20-23, emphasis added]

Dr. Klein calculates these expected referral benefits as follows:

> Suppose an eligible customer estimates a probability, p, of receiving the referral benefit, b. The customer's expected benefit from referral is this probability of referral multiplied by the benefits from referral, or pb. The customer's effective retail rate for the service is the regular retail rate less the expected referral benefits or ER = (R – pb). [p. 15, line 23 – p. 16, line 4

Q. WHAT AT&T CUSTOMERS ARE ELIGIBLE TO REGISTER FOR THE REFERRAL PROGRAM?

A. <u>All</u> current AT&T residential customers are eligible to register for the WoM referral promotion. [Stipulations for Consolidated Phase, July 23, 2010, Attachment C] Hence, Dr. Klein's resale proposal appears to require AT&T to reduce its wholesale residential service price whenever a WoM referral promotion is in effect, irrespective of whether the reseller's customer registers for the reseller's referral marketing program or actually refers a customer to the reseller and receives a payment.

Q. IS THIS A REASONABLE WAY TO IMPLEMENT MANDATORY RESALE OF AT&T'S WOM PROMOTION?

A. No. First, Dr. Klein does not specify the parameters required to implement his method — the probability p of receiving a benefit b for each eligible customer. For any AT&T customer, the benefit b depends on the program and on the number of successful referrals, and the probability p obviously varies a great deal across customers. Thus, the value of eligibility for the WoM promotion will vary a great deal across current AT&T customers. This fact distinguishes the WoM promotion from a cashback or LCCW effective price reduction, in which the benefit is effectively the same amount of cash for all participants.

Second, if b were calculated as average payment per AT&T subscriber eligible to register for the promotion, the expected benefit as calculated by Dr. Klein would grossly overstate the average benefit to a customer because it fails to account for the value of the customer's time and effort in providing the marketing service to AT&T.

Q. ASSUME THAT THE AVERAGE EXPECTED BENEFIT TO ELIGIBLE AT&T CUSTOMERS COULD BE CALCULATED. DR. KLEIN PROPOSES TO REDUCE THE WHOLESALE PRICE OF RESIDENTIAL EXCHANGE SERVICE BY THAT AMOUNT. IS THAT CALCULATION CORRECT?

A. No. Even assuming that (i) the program had to be resold, (ii) the average benefit an AT&T customer received from the program was equal to $p \times b$, and (iii) the parameters p and b could be measured, it would not be correct to calculate the wholesale price under the promotion by subtracting $p \times b$ from the regular wholesale price.

If the effective retail price reduction experienced by all current AT&T customers were equal to p×b, the analysis above for cashback promotions shows that the correct wholesale price reduction — the price reduction consistent with economic principles and Commission decisions — would be the discounted value of the effective price reduction: (1.0 – 0.148)×(p×b).

Q. DR. KLEIN ASSERTS THAT HIS PROPOSAL WOULD BE FAIR BECAUSE AT&T WOULD BE INDIFFERENT BETWEEN SERVING RETAIL CUSTOMERS UNDER THE PROMOTION AND SERVING CUSTOMERS AT WHOLESALE UNDER THE RESOLD PROMOTION. DO YOU AGREE?

A. No. Dr. Klein's proposal would simply increase the cost to AT&T of marketing its services through its referral program. Resellers would not be paid for attracting new customers to AT&T as wholesale customers; rather, they would be paid — in a reduced wholesale price — irrespective of any marketing program they did or did not put in place. And even if resellers did implement a comparable referral marketing program, AT&T's net revenue would certainly decline if it were required to pay to encourage current reseller customers to persuade their friends to shift from AT&T or from other AT&T resellers' services.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

STATE OF SOUTH CAROLINA	)	
	)	CERTIFICATE OF SERVICE
COUNTY OF RICHLAND	)	

The undersigned, Nyla M. Laney, hereby certifies that she is employed by the Legal Department for BellSouth Telecommunications, Inc. d/b/a AT&T South Carolina ("AT&T") and that she has caused the Rebuttal Testimony of Dr. William E. Taylor in Docket Nos. 2010-14-C, 2010-15-C, 2010-16-C, 2010-17-C, 2010-18-C and 2010-19-C to be served upon the following on October 1, 2010:

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